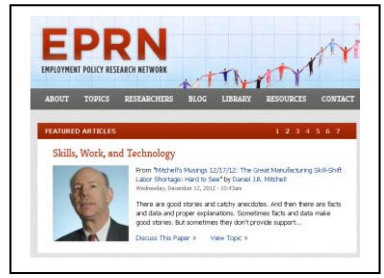
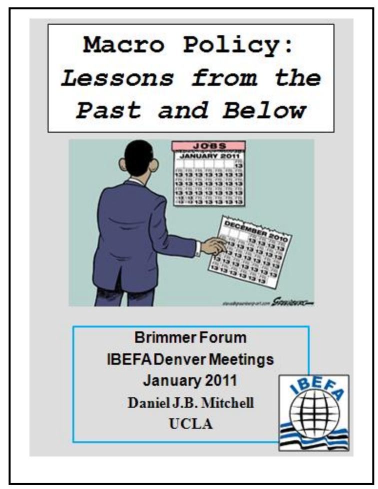
Musing on Advice for the New Administration: Five Suggestions



Daniel J.B. Mitchell*

For a little over two years, I have been writing a weekly blog/column for the Employment Policy Research Network (EPRN), the network site affiliated with LERA and supported by various foundations. Many of these weekly postings have in fact been advice – to someone about something on policy related to jobs and employment. There was a concentration on macro issues, including international trade, which have an impact on jobs and unemployment. In addition, taking advantage of audio tapes now available from the Nixon era and the Kennedy/Johnson period, I have looked at how earlier presidents responded to the economic issues of their days in office. Some of the musings dealt with government at the state and local level, particularly California, whose budget problems I have tracked for many years in annual chapters and other outlets (including LERA's latest research volume). In some instances, the postings can be described as micro comments on HR practice. All are available at www.employmentpolicy.org [click on my name] and I am drawing on a subset of them to put together advice for the new administration – advice I suspect is not generally being offered.



Apart from the EPRN musings blog/column, at the ASSA meetings just two years ago, I appeared on a "Brimmer Forum" panel that was related to today's topic. The panel was sponsored by the International Banking and Finance Association with which Andrew Brimmer – who passed away recently - was long connected. I gave advice there – advice I have given several times in the musings – which I cribbed from famed financier Warren Buffett, who gave the advice in 1987. It was ignored then. It has been ignored since. It will be ignored now. But I feel compelled to put it forth again since absent trade policy, there really is no potential job creation option. And since I will give some advice that I know will be ignored, I will also give some advice that might be followed, advice not contingent on some Grand Bargain or some congressional compromise. Let me start with things that can be done internally, i.e., that don't require legislative approval. And then I will do my Buffett thing.

Bargaining Strategy

In a recent musing, I looked at lessons that could be drawn from the (much-diminished) world of collective bargaining for negotiations more generally. It is clear that the new administration faces a

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period of divided government in which there will need to be negotiations with Congress, especially the House. At this writing, the outcome of the "fiscal cliff" is unknown. But I pointed to several lessons that could be learned from collective bargaining in that earlier musing.

One lesson is that labor negotiations are often concluded at the midnight deadline, not because bargainers aren't giving themselves enough time (which our legal framework assumes) but because of the logic of a meaningful deadline. In the collective bargaining world, the deadline is often the expiration of the existing contract.

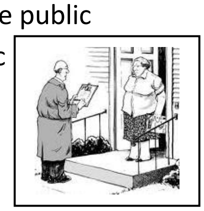
There are real consequences of going past such a deadline, basically in the tools both sides acquire at that point. Until we are close to the deadline, there is opportunity and incentive for testing the other side, bluffing, and posturing. But since real potential costs accrue at the deadline, there are incentives at that point to make a true offer and see what possible common ground exists. Obviously, the deadline can be missed and impasses and full-scale disputes can occur. But often, settlements are reached. So I predicted that the fiscal cliff would indeed be a cliff hanger.

More to the point for advice is the observation that collective bargaining is usually a repeat game in which the parties' behaviors in one negotiation condition their understanding and expectation of what to expect in the next one. Changing one's behavior requires future consistency and proof – possibly in the form of an impasse.

In previous negotiations on the Bush tax cuts and the debt ceiling, the President was seen by the opposition as someone who could be rolled. Note that the signature "Obamacare" plan ultimately wasn't produced by bipartisan compromise but was enacted by one political party through a parliamentary maneuver engineered by Nancy Pelosi. ***So my advice for current and future political negotiations is that for the President to be seen henceforth as a tough bargainer, a consistent hard bottom line will be necessary. Over the course of four years, even if hanging tough creates impasses initially, a tough consistency may in fact reduce the frequency of such events as the game repeats. Bargaining credibility can be regained, but only over time and with proof.***

Interpreting Polling Data as a Guide to Policy

We have all heard of "push polling" in which the goal of the pollster is to cause the respondent to adopt a particular opinion rather than neutrally uncover what the general opinion is. As I have followed California policy issues, however, it has become clear to me that even the "best" polls are inevitably pushing opinions. My favorite example, about which several musings were written, dealt with the public pension issue. Offered a variety of pension "reforms," poll respondents often agreed with drastic



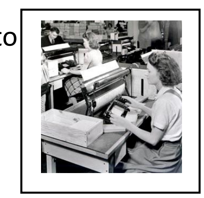
approaches such as converting everyone to 401k (defined-contribution) plans. But the reforms they agreed with were inconsistent with their responses to an initial question as to whether public pensions were too generous. Even in the face of considerable negative agitation on the pension issue, California respondents were more likely to say public pensions were at *appropriate levels or not generous enough* rather than too generous.

So why would they endorse drastic reforms if they thought there was no problem or the problem was miserly pensions? Presumably, it had to be because the pollster kept offering a menu of reforms that were in the policy space. If the pollster is offering reforms, respondents apparently came to reason that there must be a too-generous pension problem after all that needed fixing.

Let's look at polling from the viewpoint of the *incentives facing polling organizations* in the face of a public that is not focused on the various issues about which policy wonks or politicos are concerned. Pollsters have to come up with public opinions on various topics – even if the public doesn't really have opinions on them - or who will read their polls? There is an inevitable framing of questions in ways to elicit opinions about issues on which poll respondents may really have no opinion or only vague or no knowledge. If you stopped ten people in the street and asked them what the fiscal cliff was, how many could give a cogent answer?

My advice is not to worry about polls on detailed policy issues. Polls can tell you in broad terms what folks are worried about. (If you didn't know, they worry about jobs and the economy.) When it comes to detailed policy issues which most people don't follow, it is more important to frame public opinion than to cater to what even the best pollsters tell you public opinion is.

It is also important to avoid the popular metaphors that float around major issues in the news media. The U.S. turning into "Greece" is one example. In fact, Greece became contemporary Greece by giving up its currency and promising payments in a currency (the euro) not its own. The U.S. hasn't done that. Social Security described as a "Ponzi scheme" is another example. Long before there were social insurance schemes and pensions, there were intra-generational transfers within extended families to support the elderly. So unless you think your family is a Ponzi scheme, Social Security isn't one.



Government Data as a Guide to Policy

Government data on economic trends is clearly indispensable for making economic policy. There was a flurry of attacks on the accuracy of data that didn't accord with someone's view of what was happening. (Former GE CEO Jack Welch didn't like the drop in measured unemployment prior to the 2012 election and charged fraud.) In a couple of musings, I noted related episodes in which data fraud was charged that had occurred in the past. However, the fact that our data system is actually not being manipulated by dark forces doesn't mean that public data collection and distribution cannot be improved.

Some of my musings have suggested that in a sense, we get too much data in an effort to be Johnny-on-the-spot current. I was reminded of this observation by the latest release of the GDP figures for the third quarter of 2012. The advance estimate was that real GDP in that quarter rose by 2.0% at an annual

rate. Then the estimate was raised to 2.7% and most recently to 3.1%. Of course, there is seemingly a big difference between 2.0 and 3.1. But should policy be made based on these sorts of estimates and re-estimates? Would policy be harmed if we waited for enough data and dropped premature estimates?

In some cases, data are routinely released monthly (unemployment rates, the Consumer Price Index) while others come out quarterly or annually. In general, less frequent release might allow resources to be diverted to collecting more detailed information. As far as I can tell, the current frequency of data production seems to be based on tradition rather than a look at alternatives.

Finally, for key series, the government has a monopoly on much data collection and methodology. In the last couple of decades, user interests and the virtues of easy interpretation seem to have been sacrificed for theoretical reasons. It used to be said, for example, that the CPI tracked the cost of a "basket" of typical consumption items. That was a simple idea which Grandma (whose Social Security is indexed to the CPI) could understand. But you really can't say that anymore about the CPI.

For that matter, is it really helpful to have the components of real GDP not sum to total real GDP because someone liked the idea of a chained Fisher Ideal index? Did the benefits of introducing the NAICS industry breakdown into major series such as payroll employment outweigh the costs of abandoning the longstanding SIC series (thus making time-series analysis difficult)? Does anyone even ask these questions? I think there is a problem here. One symptom of a lack of user orientation is the apparent discontinuance of the popular *Statistical Abstract of the United States*, even as an online publication. And, of course, there is the important issue of the totally non-transparent "quality" adjustments that affect real GDP, productivity, and major prices indexes such as the CPI.

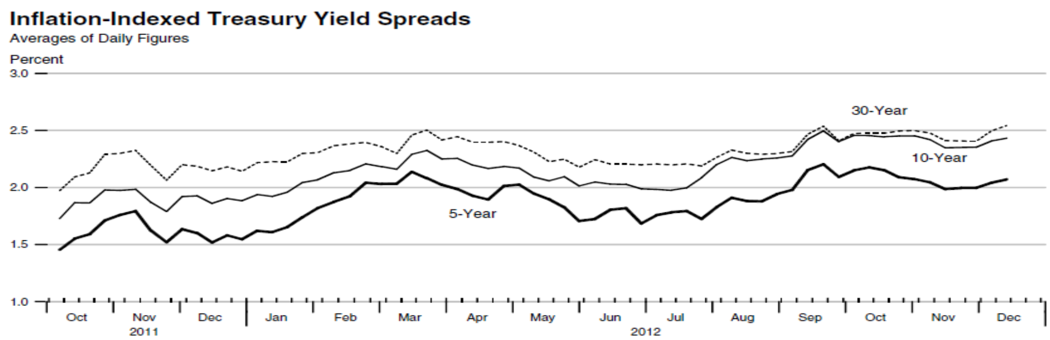
I suggest a task force be set up on federal economic data series, especially the time series that are widely used for macro policy purposes. Of course, there should be some experts on the task force of the type who love chained Fisher Ideal indexes. But I would also include business journalists, forecasters, and non-academic economists who would be asked to scrutinize key series for understandability and usability. My sense is that nowadays we breathlessly await the advance estimate of real GDP change without a clear understanding of what real GDP is. Perhaps more importantly, if Grandma's Social Security is indexed to the CPI, you should be able to explain the CPI to Grandma.

Avoid Monetarist Predictions and Policy Prescriptions

If there is any hero to emerge from the economic wreckage of 2008 and its aftermath, it is Ben Bernanke, chair of the Federal Reserve. He may not have gotten everything right – who does? - but at least he moved about as far as possible given legal constraints to a) prevent calamity and b) provide whatever stimulus close-to-zero short-term interest rates can provide. He also joined Chief Justice Roberts in taking himself out of the 2012 presidential campaign. Roberts did so by finding grounds to approve Obamacare. Bernanke did so by saying he did not want to be reappointed to another term at the Fed.

Of course, there are the Ron Paul types who think we shouldn't have a central bank. But there is another group who keep forecasting some kind of vast acceleration of inflation because the Fed has bought a vast hoard of securities to keep short-term interest rates down. Back in ancient times when I was a graduate student, there used to be monetarists and Keynesians. Monetarists tended to be free-market types; the Keynesians were more interventionist. The current crop of inflationists seems to be monetarist descendents.

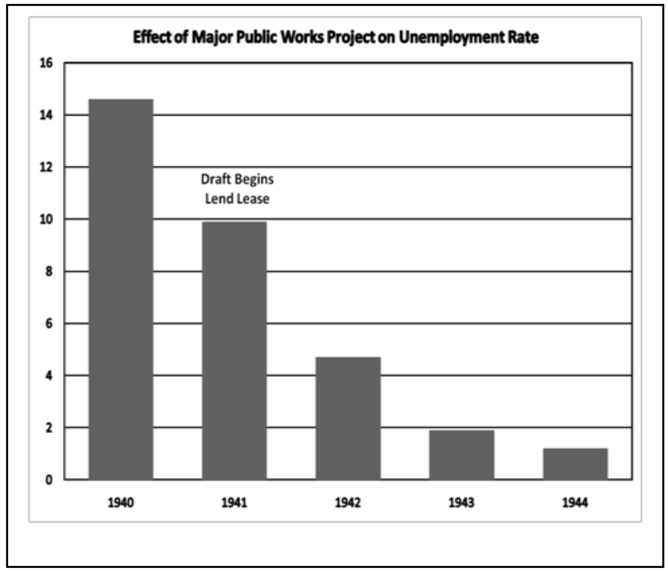
But there is a problem. Back in those ancient times, we did not have a direct measure of inflation expectations. Nowadays, thanks to the federal government's issuance of (CPI) inflation-indexed bonds, we do have such a measure. We can look at the yield spread between conventional Treasury bonds and the inflation-indexed bonds as the financial market's expectation of where the CPI is going, even over very long periods. And financial markets say that inflation will average something like 2-3%/annum, and sometimes less, over the long term which doesn't seem like hyperinflation to me.



Of course, given what happened in 2008, one might be skeptical of the wisdom of financial markets or other markets. The gyrations in the assumed inflation rate implicit in the yield spreads – even over decades when the only information is about current events – might make one cautious. But if you are a true monetarist, a true offspring of Milton Friedman, you are not allowed to doubt the wisdom of the crowds in the marketplace.

Of course, nothing is impossible. Maybe we will have hyperinflation. ***But my recommendation is that when it is time to replace Bernanke, the administration should find and nominate his long-lost identical twin. If it turns out he actually doesn't have a twin, just don't nominate a monetarist who somehow doesn't believe what financial markets predict as the likely course of inflation and instead fears hyperinflation. Otherwise, you will get premature austerity.***

Avoid Confusing What Happened and What Could Have Happened: Background to Buffett



One of the bits of folk wisdom that has floated around since the events of 2008 is that it always takes a long time to recover from major financial crises. I don't dispute that observation as an empirical fact. And it is a convenient fact since it rationalizes and justifies what has happened so far this time. The recovery has been slow, according to this rationale, because it inevitably had to be slow.

If you are doing economic forecasting – which essentially means projecting past experience into the future – making a prediction of a long recovery period once the economy bottomed out would have been a reasonable decision. The empirical/historical evidence is supportive. But the problem is that such empirical observations include both the financial triggering event *and* then the reaction of policy makers operating within institutional and ideological constraints. For example, in some future financial crisis, one observation will be that of the EU opting for austerity rather than stimulus. The move to austerity in the EU was a human policy decision, however, not an inherent force of nature.

In contrast, imagine yourself to be a benign dictator back in 2008-2009 who wanted a rapid recovery. As dictator, you control the Treasury. You can tax (or reduce taxes) at will. You can spend at will on anything including spending for direct job creation. You can bail out anyone and anything. You control the Federal Reserve. You can buy or sell anything using the Fed. I suspect a rapid recovery would have occurred under such conditions. Of course, in fact policy makers were much more constrained legally and politically compared to my hypothetical benign dictator.

The closest U.S. approximation to the dictator example occurred at the eve of World War II. Unemployment was high in 1940, the first year incidentally that the Current Population Survey actually measured unemployment. World War II amounted to a massive public works program (with spending on military products) and a massive public employment program (the draft). At its peak, the military portion of government was consuming over 40% of GDP. Indeed, there was so much demand pressure that consumer goods were rationed. The auto industry was directed, for example, to cease domestic car production and produce only military vehicles.

Despite the controversy over the bailouts and stimulus in 2008-2009, the addition to demand from fiscal policy came nowhere close to World War II's impact. The bailouts and stimulus were enough to stop the economic freefall but not much more. You can point to all sorts of political reasons why more wasn't done. ***But it really is wrong to say that the recovery is slow because crises of the type that occurred in 2007-2008 <u>must</u> entail long recoveries by some natural law. They are slow only because policy makers***

are not free generally to respond otherwise or – absent a war on the scale of World War II – they won't do otherwise.

That observation leads me finally to my Buffett plan proposal which – as I said at the outset – past evidence suggests you will ignore and policy makers will ignore. It could be followed, but won't be.

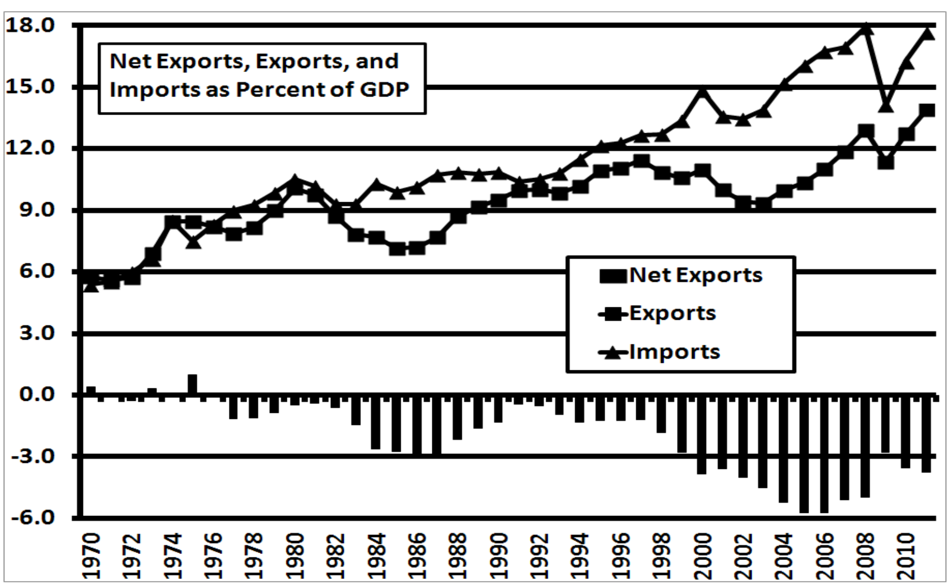
The Wrong Deficit

I noted at the outset that some of my musings have dealt with earlier presidents and their policy decisions. One of the preoccupations of presidents in the 1960s and into the early 1970s was the dollar exchange rate. At the time, the exchange rate was supposed to be fixed relative to other currencies under the 1944 Bretton Woods system. Nowadays, other than in the election context of China-bashing, you rarely hear about exchange rates.


Warren Buffett

In the 1980s, there was more discussion of exchange rate trends than now. But the villain *de jour* was Japan, not China. And it was in that environment that Warren Buffett wrote an op ed entitled "How to Solve Our Trade Mess Without Ruining Our Economy" in the *Washington Post* of May 3, 1987.

Before I go further with what Buffett (and I) propose, let me indicate why the proposal – which seems to be about international trade – is in fact a jobs program. First, let's note the obvious. Under current political alignments, there will not be any explicit additional jobs stimulus program. Second, the U.S. has run a net export (goods and services) deficit since the mid-1970s. A country which runs a net export deficit (buys more from the world than it sells) must finance the gap by either running down a past store of assets and/or by running up debt. In fact, the U.S. has become the world's largest debtor. It has so far been able to do so because official entities - such as foreign central banks - and private investors have been willing to hold an ever-expanding volume of dollar assets.



Some countries, such as China, are willing to control their exchange rates to keep their exports flowing to the U.S. Whether or not this policy is rational for China as a society, that is what China does. It at least benefits the elites who run the country. It creates jobs in China, which holds down unrest. But it's not just Chinese policy makers. Private investors worldwide have viewed the dollar as an international currency – which it has been since the end of World War II. So they have absorbed the outflow of dollars.

However, the ongoing pile up of foreign holdings of dollars (which are mainly held privately) poses a financial risk. What if there were a run on the dollar? Would it just take the benign form of a smooth dollar depreciation? What if some too-big-to-fail financial entity turns out to have assumed that the dollar wouldn't fall and suddenly needs a bailout? The current political climate would likely preclude such action. In short, at this point, bringing down the net export deficit would be both a demand/jobs stimulus and at least a step towards averting an uncertain eventual reaction to ongoing net export deficits. ***Thus, despite all the concern about the federal budget deficit, the deficit to focus on and correct is the net export deficit. We are worrying about the wrong deficit.***

If the U.S. were currently at full employment, an exogenous shock moving the negative net export balance to zero would create excess demand and inflation. But the U.S. is decidedly not at full employment. And other than Bernanke's low interest rate policy, there is nothing fiscal policy is doing to add to demand.

When the nation was last at something like full employment in 2006, the net export deficit amounted to almost 6% of GDP. The Great Recession cut import demand more than foreign demand for U.S. exports and thus dropped the deficit to around 3% of GDP. But as the recovery developed, by 2011, the deficit had risen towards 4%. These are large magnitudes, particularly when one considers that no other additional stimulus will be forthcoming.

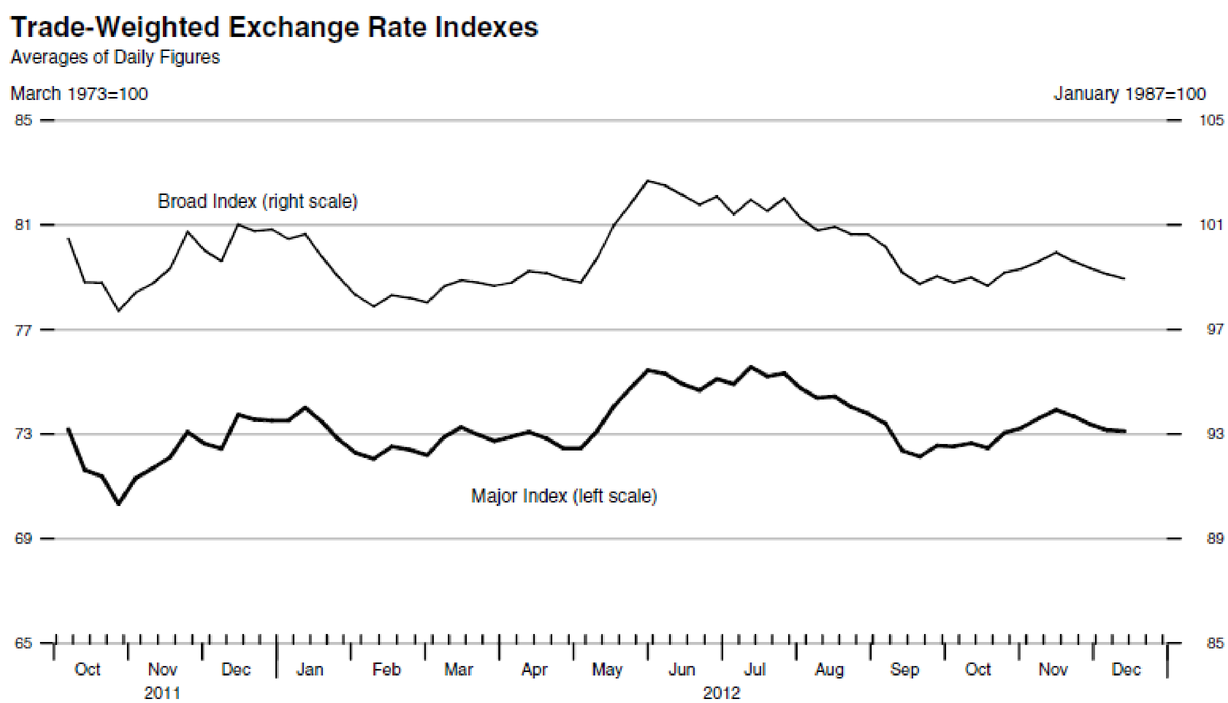
In what sector would the added jobs be located if the U.S. net export balance went to zero? Much of international commerce, even when services are included, involves trade in "things." Some of those things are agricultural or mineral products (e.g., wheat, oil). But when you look at exports and imports of the U.S., roughly half involves manufactures. Now manufacturing accounts for only about a tenth of employment in the larger domestic economy. So let's assume that we closed the net export deficit and increased the number of jobs through more exports and through import substitution by 3%. If half of those jobs were in manufacturing, they would amount to a 15% increase in employment in that sector.

As a side note, ***please avoid the twin fallacies of 1) manufacturing is not coming back and 2) there is a vast manufacturing skill shortage preventing it from coming back.*** I have explored both in my Mitchell's Musings blog. The first is incorrect because the only way the U.S. can ultimately repay its international debt is by net exporting which – as just noted – is heavily manufacturing-oriented. The second is based on anecdotes from a sector which has gone from a long period of labor shedding (going back well before the Great Recession) to a bit of expansion. Manufacturers have to relearn how to recruit; the problem is on the employer side, not the worker side.

Short of some elaborate controls program, the U.S. has only a limited influence on the dollar exchange rate. Estimates can be made of what exchange would be consistent with a zero net export balance. But no one can know for sure. However, as Warren Buffett pointed out back in 1987, there is a market solution. In effect, he proposed a variant on cap and trade.

The essence of the Buffett plan was simple. Anyone exporting a dollar's worth of goods or services from the U.S. would get a voucher permitting the import of a dollar's worth of goods and services. The value of imports is therefore capped at the value of exports. The recipient of the voucher could exercise it directly or sell it to an importer. Essentially, the prevailing exchange rate plus the value of the Buffett voucher produces a *de facto* exchange rate faced by exporters and importers equal to the exchange rate that is consistent with a zero net export balance. *Note that no single country is singled out for bashing.* Anyone can buy or sell anything from anywhere but at the end of the day exports = imports. (The plan could be phased in over time since the voucher value could initially be set at greater than $1.)

Are there administrative complications with the Buffett plan? You would have to have a mechanism for verifying true values of exports and imports. Note that we already do such an evaluation on imports via customs inspections for tariff assessments. There are issues related to service exports and imports such as royalties on intellectual property (movies, TV shows, music, books, etc.) and tourism. But since this proposal will be ignored, we don't have to dwell on those complications.



Probably, you will initially want to ignore the proposal because it is "protectionist." But if you do the math, you will see that it is simply a *de facto* downward move in the dollar exchange rate. The dollar goes up and down relative to other currencies all the time. Is every decline "protectionist"? Another objection is that it involves "unilateral" action by the President when we should obtain agreement by all

other countries. As I have noted in my EPRN musings, Nixon unilaterally ended the entire Bretton Woods exchange rate system in 1971. (You can see him do it on TV on my YouTube channel: www.youtube.com/danieljbmitchell. [Search under "Nixon."]) Presidents can act boldly if they want to.

By the way, the likely outcome of a U.S. policy announcement that the Buffett plan would be implemented would in fact be a call for an international conference to deal with exchange rate manipulation and unsustainable trade imbalances. I don't know what the outcome of such a conference would be. But it is at least possible that if the U.S. took the unilateral step of announcing the Buffett plan, some kind of new multilateral deal would follow and the Buffett plan would not actually have to be implemented.

Of course, if you don't like the Buffett plan but have no alternative to suggest, you can fall back on the idea that steps are already underway to correct the trade problem. The Chinese are raising the value of the Yuan, albeit at a snail's pace. The unemployment rate is coming down. In fact, the U.S. runs a net export deficit with just about every significant trading partner; it isn't just the Chinese. And the gradual U.S. economic recovery will add to the net export deficit. The problem is not solving itself, contrary to what some observers would like to believe.

My advice is that we implement the Buffett voucher plan. You can pick whatever reason you like to ignore my advice. (But do tell me your better idea for job creation when you ignore mine.)

Summary

I have provided five pieces of advice to the new (re-elected) Obama administration, one of which is sure to be ignored – based on past evidence - and any of the others could be ignored. If the advice isn't followed, at least I have done my citizen's duty by offering it.

- *In current and future political negotiations, for the President to be seen henceforth as a tough bargainer, a consistent hard bottom line will be necessary. Over the course of four years, even if hanging tough creates impasses initially, the consistency may in fact reduce the frequency of such events as the game repeats. Bargaining credibility can be regained, but only over time.*

- *Don't worry about polls on detailed policy issues. Polls can tell you in broad terms what folks are worried about. (If you didn't know, they worry about jobs and the economy.) When it comes to detailed policy issues which most people don't follow, it is more important to frame public opinion than to cater to what even the best pollsters tell you public opinion is. Remember that pollsters have a strong incentive to tell you about public opinion even if the public really has no deep felt or knowledgeable opinion.*

- *A task force should be set up on federal economic data series, especially the time series that are widely used for macro policy purposes. Of course, there should be some experts on the task force of the type who love chained Fisher Ideal indexes. But I would also include business journalists, forecasters, and non-academic economists who would be asked to scrutinize key series for understandability and usability. If Grandma's Social Security is indexed to the CPI, the CPI should be explainable to Grandma.*

- *When it is time to replace Ben Bernanke as head of the Federal Reserve, the administration should find and nominate his long-lost identical twin. If it turns out he actually doesn't have a twin, just don't nominate a monetarist who sees a future of hyperinflation. Otherwise, you will get premature austerity.*

- *Despite all the concern about the federal budget deficit, the deficit to focus on and to correct is the net export deficit. We are worrying about the wrong deficit. My advice is that we implement the Warren Buffett voucher plan which would quickly bring the net export deficit to zero. It would create jobs particularly in manufacturing. And it would help avert a future international dollar financial crisis. You can pick whatever reason you like to ignore this proposal; it has been ignored since 1987 when it was initially put forward. But – please - first come up with a better idea for creating jobs.*